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UNCLAS SECTION 01 OF 02 ISLAMABAD 001355

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SENSITIVE

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TAGS: ECON EFIN EINV PGOV PREL PK
SUBJECT: Budget 2009-10: Depending on Foreign Assistance

¶1. (SBU) Summary: On June 13, the GOP presented a consolidated budget of $36.21 billion with a fiscal deficit of 4.9 percent, slightly higher than the 4.6 percent target previously agreed to with the International Monetary Fund. The budget is fairly expansive, with development expenditures increasing by 54 percent. Subsidies have been cut by $1.25 billion, but Tarin told reporters that the GOP "had not yet made up its mind" about completely eliminating electricity subsidies. While tax targets are 17 percent above the current year, the new tax measures do not appear sufficient to raise this amount of revenue. The IMF has expressed concern about whether some expenditures might be underestimated, as well as with the 4.9 percent deficit. Finance Advisor Tarin, however, said that if promised Tokyo and IDP donor assistance pledges materialize, the deficit would be only 3.4 percent of GDP. As an added precaution, he has requested an additional $3 billion from the IMF as a back up credit, which the Fund's Board will consider when it meets in July. Growth and inflation targets appear to be optimistic, given the current slump in the manufacturing sector and continuing energy shortages. The National Assembly will debate the budget for the next ten days, but discussion is not expected to be particularly contentious. End Summary

Counting on Donor Assistance to Bring Deficit Down

¶2. (SBU) On June 13, Minister of State for Finance and Economic Affairs Hina Rabbani Khar presented the budget for the fiscal year beginning July 1 to Parliament. The consolidated federal and provincial budgets came in at $36.2 billion: total resources are expected to be $27.2 billion, leaving a deficit of $9.03 billion, or 4.9 percent of GDP. Development expenditures are $9.79 billion - up 54 percent from last year. Of this, slightly over $8 billion will be for the public sector development program (PSDP); $875 for the Benazir Income Support Program; and $625 million for internally displaced people. The new "IDP tax" - a 5 percent charge on individuals whose taxable income exceeds $12,500 - is expected to raise an additional $17 million for the displaced persons of Swat, Dir and Buner. Government employees and retirees will receive a 15 percent increase in salaries and pensions, and military personnel will receive bonuses for service on the western front.

¶3. (SBU) Finance Advisor Shaukat Tarin explained that the 4.9 percent deficit would fall to 3.4 percent if international assistance materialized as promised. Tarin said that the GOP had requested an additional $3 billion from the IMF, but that it would be used only as back-up, in case other assistance was not

forthcoming.

Focus on Manufacturing, but no Concrete Measures

¶4. (SBU) In a June 14 press conference, Tarin said the current budget would phase out unproductive subsidies and prioritize government spending. The GOP will focus on reviving the manufacturing sector, which had shrunk by 3 percent in FY08-09, "through easy monetary and realistic exchange rate policies." The GOP is planning for a 3.8 percent growth in agriculture, 1.8 percent growth in manufacturing and 3.9 percent growth in services, for an overall GDP growth rate of 3.3 percent. Inflation is projected to be 9.5 percent over the course of the fiscal year. Exports are projected to be $18.3 billion, while imports are expected to drop by 5.6 percent to $28.9 billion. The trade deficit is projected at $10.7 billion in FY09-10.

Revenue Targets up 23 Percent

¶5. (SBU) Despite pressure from the IMF and other international financial institutions to increase its tax-to-GDP ratio, Tarin said this would remain at 9 percent for the upcoming year. Revenue targets are planned to increase by 23.3 percent, however, to $17.15 billion. Tax revenue targets are up 17 percent. (Note: The tax-to-GDP ratio will remain relatively unchanged since nominal GDP will increase by 12.8 percent. End Note.) To meet this goal, the GOP has instituted several new tax measures, although the sacred cow - agriculture - remains untouched. It has levied a 16 percent excise tax on services provided by banking and financial companies, insurance companies, port/terminal operators, and stock brokers, as

well as a 16 percent tax on print advertisements. The government has increased both the tax rate on the transfer of real estate and the withholding tax on imports from 2 to 4 percent.

Overall Subsidies Down, Fate of Electricity Subsidies Unclear

¶6. (SBU) GOP spending on subsidies has been reduced from $2.75 billion to $1.5 billion for the coming year. Of this amount, $846 million is for wheat and $837 million is for power. Of the latter, $125 million will subsidize FATA electricity, $375 million will pay interest on Pakistan Electric Power Corporation's debts, and $150 million is to clear tariff differential arrears or "circular debt." However, it is not yet clear whether the GOP will fully live up to its commitment to the IMF to phase out electricity subsidies overall or to fully recover costs for electricity production, which would require raising tariffs by 17.5 percent. In his June 14 press conference, Tarin said the government "had not yet decided" by how much it would increase the electricity tariff.

¶7. (U) The provincial share of federal revenue is estimated at $8.19 billion for FY09-10, a 15.3 percent increase over last year. The defense budget for 2009-10 has been increased to $4.29 billion from $3.89 billion.

Agriculture and Industry Ministries Get More Funds

¶8. (SBU) The Agriculture Ministry will receive an additional $50 million this year, for a total budget of $225 million. In addition, two new R&D laboratories - one for wheat and one for cotton - will be established. In other agriculture related spending, water course improvements have been allocated $125 million, improvements to the Mangla Dam have been given $150 million, small and medium dams received $94 million, and $187 million was allocated for irrigation system rehabilitation. The budget for the Industries Ministry was increased from $25 million to $109 million.

Petroleum Levy Replaced By Carbon Tax

¶9. (SBU) The petroleum development levy (PDL) was replaced by a a "carbon tax" on petroleum products and compressed natural gas, in response to a ruling by the Supreme Court that declared the PDL unfair. The government expects to earn $1.675 billion from the new tax, an amount similar to that raised by the PDL.

Tax Incentives for Industry

¶10. (U) The five per cent excise tax on cars has been withdrawn and exemptions granted for inputs necessary for manufacturing parts and components for engineering sector. The government has reduced the excise tax on telecommunication services from 21 to 19 percent, and halved the activation charges on cell phones from $6.25 to $3.12.

¶11. (SBU) Comment: The budget has met a generally luke-warm reception. A former Commerce Secretary told us that the budget lacked a unifying theme to rally the Pakistani people, such as stressing the security situation or asking for sacrifices in the face of the IDP crisis, but focused instead on "business as usual." Several interlocuters remarked that the GOP had not tightened discretionary spending, observing that such an expansionary budget would create excessive demand, which, coupled with rising international oil prices, could reverse recent improvements in the current account deficit. The IMF Res Rep noted that special interests continued to receive preferential treatment, and that the Fund had concerns about the ability of the GOP to stick to its spending plan if the global situation did not improve. Former Finance Minister Salman Shah noted that the revenue targets were quite ambitious for a stagnating economy. Pakistan is counting heavily on foreign assistance, but there is uncertainty as to the timing as well as the form of promised assistance. If assistance does not materialize as budget support, Pakistan may have to raise money domestically or cut development spending, which could have negative implications for growth and inflation, as well as on public opinion.

PATTERSON